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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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In the Matter of	)	
	)	
1998 Biennial Regulatory Review --	)	CC Docket No. 98-137
Review of Depreciation Requirements	)	
for Incumbent Local Exchange Carriers	)	
	)	

REPLY COMMENTS OF THE AD HOC TELECOMMUNICATIONS USERS COMMITTEE

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The Ad Hoc Telecommunications Users Committee (hereinafter "Ad Hoc" or "the Committee") hereby submits reply comments in response to the Federal Communications Commission's ("Commission") October 14, 1998, Notice of Proposed Rulemaking ("NPRM") in the above-captioned proceeding seeking comment on proposals which would change the Commission's depreciation prescription process and potentially eliminate the prescription of depreciation rates for Incumbent Local Exchange Carriers ("ILECs").

SUMMARY

Comments filed by the United States Telephone Association ("USTA") and the price cap LECs suggest the ILECs are unwilling to be subject to conditions that are logically associated with a granting of forbearance from depreciation regulation. Ad Hoc urges the Commission to reject the ILECs' efforts to secure forbearance from depreciation regulation without agreeing to appropriate conditions such as set forth in

.d Hoc's comments. The Commission should adhere to its tentative conclusion that carriers should be allowed to set their own depreciation rates if and only if appropriate conditions are imposed so as to sever the remaining links between depreciation rates and prices charged by price cap LECs. As set forth in Ad Hoc's initial comments, these conditions are – in absolute terms - the elimination of the low-end adjustment mechanism and the requirement that LECs forego the opportunity to seek special recovery of depreciation reserve deficiencies or to make takings claims under the Fifth Amendment.

A careful review of the ILEC comments reveal that where ILECs appear to agree to accept these types of conditions, the conditions to which the ILECs actually agree are themselves conditioned on numerous factors that would preserve for the ILECs the ultimate right to seek special recovery of embedded investment. The conditions imposed on the ILECs in exchange for forbearance from depreciation regulation must be absolute. Otherwise, the granting of forbearance would result in an situation where price cap LECs are given the same freedom to set depreciation rates as afforded their unregulated competitors but are allowed to maintain the ability to seek special recovery of embedded costs and to price at above-market levels -- economic privileges and inefficiencies that are simply not present in a competitive market environment. It is only proper that the ILECs be asked to choose between the regulatory security of being made whole with respect to embedded investment and the opportunities afforded firms operating in a competitive marketplace such as the flexibility to set depreciation rates. For the ILECs to be given the opportunity to do both is clearly not in the public interest.

The Commission must not be persuaded by ILEC arguments that unless they are

,ade whole with respect to all *past* investments, ILECs will not invest in efficient technology in the *future*. As discussed in these reply comments, such arguments defy sound economic principles. Furthermore, the same fundamental economic/market conditions which the ILECs cite as supporting the setting of depreciation rates underlying the provision of access services on the basis of a purely forward-looking analysis would also argue for the setting of access charges at levels reflecting forward-looking rather than embedded cost levels.

As USTA's own experts have acknowledged, the Commission has in the past relied on market share tests as material to whether to qualify firms as dominant versus non-dominant or otherwise determine the competitiveness of telecommunications markets. As discussed in these comments, none of the reasons cited by USTA's experts as to why market share is not a good measure of market power in the context of the issues addressed in this NRPM are persuasive. Commission reliance on structural measures of market power, such as market share, is just as appropriate in the specific context of determining when competition is sufficient to permit forbearance from depreciation regulation, as it has been in the context of determining non-dominance of telecommunications carriers generally.

I. ARGUMENTS PRESENTED BY USTA AND THE ILECs IN SUPPORT OF FORBEARANCE OF DEPRECIATION REGULATION THAT CITE FAIRNESS AND EFFICIENCY ALSO DICTATE THAT ILECs REDUCE ACCESS CHARGE RATES TO FORWARD-LOOKING COST LEVELS AND RELINQUISH ALL CLAIMS TO EMBEDDED COST RECOVERY.

In their comments, USTA and the price cap LECs argue - as expected in light of the previously-filed USTA Petition - that depreciation regulation is a hold over from rate

...n regulation that has no place in the competitive market environment that allegedly now characterizes the telecommunications industry.[1] They take the position that depreciation regulation must be removed if price cap LECs are to be able to compete on a fair and economically efficient basis.[2]

Putting aside Ad Hoc's fundamental disagreement with the argument that price cap LECs face competition sufficient to constrain their ability to recover higher depreciation charges such as would result from forbearance – a position evidently shared by the Commission,[3] if USTA and the LECs are going to argue fairness and economic efficiency as the basis for depreciation forbearance, they must also accept the other logical implications of those doctrines. In particular, both fairness and economic efficiency would demand not just that LECs be granted forbearance from depreciation regulation, but also that LECs reduce access charges from historic embedded levels to forward-looking cost levels and relinquish claims to recovery of depreciation reserve deficiencies associated with past investment.

USTA argues that "[d]epreciation regulation has largely been based on historical, backward-looking analysis that is no longer relevant to the competitive investment decisions being made by the ILECs."[4] What USTA fails to acknowledge, however, is that access rates - and the notion of embedded cost recovery in general – are similarly "largely based on historical backward-looking analysis." As discussed in Ad Hoc's

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1 *See, e.g.*, USTA Comments at 6, US West Comments at 4-6, BellSouth Comments at 5-6.

2 *See, e.g.*, USTA Comments at 6, US West Comments at 11.

3 *See* Ad Hoc Comments at 7, NPRM at para. 7.

4 USTA Comments at 4.

comments, the ILECs should not be allowed to have it both ways. If the ILECs want depreciation rates underlying the provision of access services to be based on purely forward-looking analysis, then access charges too must be set to reflect forward-looking levels. Otherwise, as Ad Hoc noted, the granting of forbearance would result in an situation where price cap LECs are given the same freedom to set depreciation rates as afforded their unregulated competitors but at the same time maintain the ability to recover embedded costs and price at above-market levels -- economic privileges and inefficiencies that are simply not present in a competitive market environment.[5] Indeed, the very same fundamental conditions that the ILECs cite as support for the setting of depreciation rates underlying the provision of access services on the basis of a purely forward-looking analysis would also argue for the setting of access charges at levels reflecting forward-looking levels.

The assertion by USTA experts that the failure to lift regulatory restrictions on depreciation will distort efficient technology choices and lead to efficiency losses including fewer advanced services and higher prices[6] is simply not a credible economic argument. Any efficiency losses that might possibly result as a consequence of depreciation regulation are dwarfed by efficiency losses that currently exist as the consequence of access charges being set far in excess of competitive or forward-looking cost levels. According to fundamental economic principles, the most direct way to reduce efficiency losses is to lower rates to cost. The access charge market is no

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5 *Id.* at 3.

6 Affidavit of W.E. Taylor and A. Banerjee, Attachment A to USTA Comments, at 9.

exception. As far as technology choices go, for USTA's experts to imply that LECs will not invest in efficient technology on a going forward basis because of regulatory constraints on their ability to recover past investment is completely at odds with another fundamental economic principle, namely that economic decisions are made without regard to sunk costs. Indeed, for LECs to decide not to invest in efficient technology would require economically irrational behavior. It would simply not be in the economic interest of the ILECs to shun investment in efficient technology, which by definition, would reduce ILEC costs and/or increase ILEC revenue streams, and thereby pass standard capital budgeting analysis. Certainly no ILEC could seriously argue given their remarkably high rates of return that they were unable to fund investments for which capital budgeting analysis showed as presenting a positive net present value result.

II. THE COMMENTS FILED BY USTA AND THE ILECs CONFIRM THAT PRICE CAP LECs SEEK THE SAME FLEXIBILITY TO SET DEPRECIATION RATES AS UNREGULATED COMPANIES WITHOUT ACCEPTING THE RISK OF EMBEDDED COST RECOVERY THAT GOES HAND IN HAND WITH THAT FLEXIBILITY.

As a general proposition, the ILECs appear unwilling to be subject to conditions that are logically associated with a granting of forbearance from depreciation regulation. For the most part, the ILECs argue against the need for conditions, as opposed to proposing conditions that address the situations identified in the NPRM as areas where depreciation would have a significant effect.[7] Moreover, in most every instance where

[7] *See, e.g.*, Ameritech Comments at 6-9; US West Comments at 7-9.

the ILECs appear to agree to conditions, their agreement is far from absolute. A careful review of the ILEC comments reveal that the conditions to which the ILECs would agree are themselves conditioned on numerous factors that would preserve for the ILECs the ultimate right to seek special recovery of embedded investment.

For example, even BellSouth – the ILEC cited in the NPRM as proposing the Commission allow carriers to set their own depreciation rates on the condition that they not seek a low-end adjustment[8] – clarifies in its comments that its proposal would not completely preclude an ILEC setting its own depreciation rates from seeking a low-end adjustment. While an "automatic" low-end adjustment would not be permitted, the BellSouth proposal would permit an ILEC setting its own depreciation rates to "initiate" a low-end adjustment which the Commission would investigate based upon "pertinent test criteria."[9] BellSouth further weakens its proposal by noting that it had "caveated its [earlier] position to be dependent on the current price regulation plan" and that "[a]ny major change to that plan, such as movement to a prescriptive approach, could reinstate the need for low-end adjustments."[10] These caveats render BellSouth's proposed condition that ILECs agree to waive the low-end adjustment effectively meaningless. USTA's experts similarly would leave the door open for ILECs who have supposedly agreed to a waiver of the low-end adjustment to seek one, provided they "be required to justify their depreciation practices and earnings calculations to the

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8 NPRM at para. 8.

9 BellSouth Comments at 17.

10 *Id.*

Commission."[11] Such a process would appear to defeat the very purpose of forbearance, and given the ILEC would not have been subject to depreciation filing requirements, parties as well as Commission staff seeking to analyze the ILEC request likely would be at a significant disadvantage.

It is certainly understandable that the LECs would be reluctant to relinquish the vestiges of embedded cost recovery such as the low-end adjustment that they continue to enjoy under the Commission's price cap regulation. However, the LECs must understand that as they increasingly seek the flexibility enjoyed by companies in the non-regulated sector of the economy, such as the flexibility to set their own depreciation rates,[12] they must also be willing to be subject to the same risks faced by those companies. Particularly relevant to the issue of forbearance from depreciation regulation is that the LECs must be willing to accept the risk of embedded cost recovery faced by firms operating in a competitive marketplace. Quite simply, firms operating in a competitive marketplace have no guarantees of embedded cost recovery.

III. ILECs LARGELY IGNORE THE COMMISSION'S DIRECTIVE TO ADDRESS THE EFFECT OF DEPRECIATION REGULATION ON TAKINGS CLAIMS; THOSE THAT ADDRESS THE ISSUE WRONGLY DISCOUNT ITS SIGNIFICANCE IN REGARD TO PAST INVESTMENT.

As noted in Ad Hoc's comments, of the situations identified in the NPRM as areas where depreciation has a significant impact, perhaps the greatest exposure end

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[11] Affidavit of W.E. Taylor and A. Banerjee, Attachment A to USTA Comments at 13-14.

[12] For example, Taylor and Banerjee argue that "ILECs that compete with new entrants must enjoy the same flexibility in their depreciation practices that their unregulated rivals do." Affidavit of W.E. Taylor and A. Banerjee, Attachment A to USTA Comments at 9.

users would face from the deregulation of depreciation is the LECs' ability to assert claims under the Fifth Amendment.[13] Ironically (or perhaps intentionally), USTA and the ILECs largely ignore this very significant issue in their comments. Moreover, in the few instances where this issue is addressed, the significance of potential claims with respect to the recovery of past investment is either ignored or seriously discounted.

For example, BellSouth suggests that if the Commission allows ILECs to set their own depreciation rates, "the carriers could not claim that the Commission denied the carrier a reasonable opportunity to recover its capital investment" and that "[f]orbearance avoids this problem." BellSouth's superficial dismissal of the ability of carriers to make a takings claim does not specifically address the recovery of past investment.

USTA, on the other hand, clearly contends that under forbearance ILECs would retain the ability to seek recovery relating to past depreciation deficiencies. First in its Petition, USTA specifically asserted the right of ILECs to make a case for "recovery of *any* depreciation reserve deficiencies that may exist."[14] Cincinnati Bell notes its specific agreement with the USTA Petition on the point that "granting forbearance should not preclude price cap LECs from recovering reserve deficiencies that exist as a result of *past* depreciation regulation."[15]

In its comments, USTA conceded only that forbearance "would narrow the analysis of the takings issues" – not that it would remove the problem entirely. Indeed,

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13 Ad Hoc Comments at 7.

14 USTA Petition at 2, 18-19, *emphasis added.*

15 Cincinnati Bell Comments at 10, *emphasis added.*

USTA was quite specific in asserting that "[e]limination of depreciation regulation would transfer to the ILECs' control over and responsibility for their capital recovery programs *going forward from implementation,"* and that "[t]his would narrow the analysis of takings issues, since it would *limit the potential* for Commission action to take private property without just compensation."[16] In making this statement, USTA is drawing a clear distinction between past and future capital recovery issues, with USTA preserving for its members the right to make takings claims in connection with past capital recovery programs – *i.e.,* capital recovery programs prior to forbearance.

In its comments, Ad Hoc presented evidence that the ILECs could seek to recover from access charge customers (and ultimately end users) as much as $5-billion related to depreciation reserve deficiencies based upon depreciation rates unilaterally set by the LEC under the new forbearance regime.[17] Ameritech in its comments cites a total company RBOC/GTE reserve deficiency figure of $34 billion that suggests ILECs could seek an even higher amount from interstate access customers.[18] Ameritech proceeds however to give short shrift to the significance of the takings claim issue. Ameritech states only that "forbearance from depreciation regulation will diminish or remove ILEC claims under the Fifth Amendment, since ILECs will be solely responsible for depreciation decisions." [19] Ameritech provides no accompanying explanation or further discussion of this issue. In light of USTA's stated positions on this matter, and

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16 USTA Comments at 6, *emphasis added.*

17 *Id.* at 8.

18 Ameritech Comments at 14.

19 *Id.* at 9.

Ameritech's expressed "full support" of the USTA Petition, Ameritech's statement with regard to the takings claim issue can hardly be interpreted as a firm commitment on the part of Ameritech to forego takings claims under the Fifth Amendment.

Given the potential magnitude of the dollars involved and the substantial impact on access charge rates, the effect of depreciation on ILEC takings claims is substantial and cannot be ignored or dismissed lightly. Ad Hoc reiterates its position that if the public interest is to be served by the elimination of depreciation regulation, the ILECs must agree to the condition to forego the opportunity to seek special recovery of *any* depreciation reserve deficiencies or takings claims under the Fifth Amendment – specifically including those related to past investment decisions and capital recovery programs.[20] Ad Hoc notes its position is supported by the Florida Public Service Commission (FPSC). In responding to the USTA position that ILECs not be precluded from seeking to recover any existing depreciation reserve deficiencies, the FPSC states its belief that "it is reasonable for the carriers to accept the existing reserve positions irrespective of imbalances in exchange for forbearance."[21]

As in the case of the low-end adjustment mechanism, the ILECs' willingness to forego opportunities for additional revenue recovery related to depreciation reserve deficiencies or takings claims under the Fifth Amendment must be absolute – meaning that the LECs must agree not to subsequently argue a case for recovery. Otherwise,

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[20] Ad Hoc Comments at 3, 7-10.

[21] FPSC Comments at 8-9. The FPSC goes on to state that should the Commission allow reserve corrections, it should consider "stranded benefits" as well. Ad Hoc believes it much simpler and fairer for the Commission to require carriers to accept existing imbalances in exchange for forbearance.

the whole notion of conditions as the *quid pro quo* for forbearance from depreciation regulation will be a sham.

IV. USTA'S ARGUMENTS AGAINST COMMISSION RELIANCE ON STRUCTURAL MEASURES OF MARKET POWER - SUCH AS MARKET SHARE - TO DETERMINE WHEN COMPETITION IS SUFFICIENT TO PERMIT FORBEARANCE ARE NOT PERSUASIVE.

The NPRM expressed the Commission's belief that "[a]s soon as robust competition exists in the local exchange market," depreciation regulation could be eliminated.[22] While the Commission correctly found that such robust competition does not exist at the present time, the NPRM sought comment on the criteria by which the Commission could determine whether sufficient competition exists to permit the elimination of the depreciation prescription process.[23] USTA's experts argue in response that the threshold of robust competition is undefinable and contentious, particularly if a market share loss test is used.[24] They cite four reasons why market share is not a good measure of market power, all of which seek to obscure the real reason why ILECs would object to a market share test, namely that under this standard, the Commission would find a lack of effective competition in the local exchange market for the foreseeable future. To this end, they dismally fail.

The first reason presented is based on contestability theory and its implication that "even a firm with near 100 percent market share cannot raise prices arbitrarily

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22 NPRM at para. 7.

23 *Id.* at para. 7, para. 19.

24 Affidavit of W.E. Taylor and A. Banerjee, Attachment A to USTA Comments at 10.

without risking hit-and-run entry by small, efficient competitors." [25] As a threshold matter, the theory of contestable markets has not been accepted in mainstream economics. Moreover, even if one were willing to accept this theory, USTA's experts present absolutely no evidence to support their claims that hit-and-run entry of the scale needed to constrain the ILECs would be feasible in the local exchange market. Nor could they, given the conditions under which CLECs currently operate at the mercy of ILECs as evidence in the various Section 271 proceedings around the country attest.

Second, USTA's experts suggest that market share cannot measure market power because there is "no room for monopolistic price manipulations" under price cap regulation.[26] Once again, the argument is based on an unsupported premise. In fact, there is ample room for various forms of manipulation under price cap regulation as the numerous complaint and rulemaking filings before the Commission since the adoption of price cap regulation demonstrate. Moreover, while it is true that rates are set based upon a formula involving principally the rate of inflation, exogenous costs, and a productivity offset, the last two factors are subject to a great deal of contention and present the opportunity for significant manipulation on the part of ILECs. Furthermore, as the NPRM points out, there are numerous areas remaining under price cap regulation where the link between costs and rates remain, notwithstanding the application of the price cap formula.[27]

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25 *Id.*

26 *Id.* at 11.

27 NPRM at para. 6.

The third reason cited in opposition to market share measures is that the structure of the local exchange market (specifically, the minimum efficient scale that entrants would have to reach to be viable competitors) may allow for "only a small handful of competing firms."[28] This reason is unpersuasive at many levels. First, the argument is inconsistent with the ILECs' often stated claims they face potential competition from a large number of competing firms, not to mention the authors' own reference to contestability theory which depends upon "risking hit-and-run entry by small, efficient competitors." Second, even if the structure of the local exchange market permitted only a few viable competitors from emerging, market share measures are still meaningful. For example, the Herfindahl-Hirschman Index (HHI) used in the Department of Justice Merger Guidelines, take into account the size distribution of firms in addition to the mere number of firms, such that even in a market with only a few competitors, market share measures provide meaningful measures of the robustness of competition.[29] As a general proposition, the more evenly distributed the individual firm market shares are, the more competitive the market will be, and this holds true whether there are four of forty firms in the market.

USTA's experts acknowledge the Commission's past reliance on market share tests "to qualify firms as being non-dominant or otherwise competitive."[30] Their expressed fear that a market share test would "set up an unreachable goal for ILECs" is without economic foundation. As in the case of the long distance market, a market

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28 Affidavit of W.E. Taylor and A. Banerjee, Attachment A to USTA Comments at 11.

29 *1992 Horizontal Merger Guidelines*, Fed. Reg. 41552, at § 1.5.

30 Affidavit of W.E. Taylor and A. Banerjee, Attachment A to USTA Comments at 11.

share test for the local market may take time to reach, but there is no reason to believe such a goal is less attainable – provided the ILECs make the effort to comply with the mandates of the Telecommunications Act relative to the opening up of their networks. The fact is it is the ILECs themselves who are largely in control of the pace with which a market share measure will demonstrate the existence of robust competition. Again, the evidence available through the Section 271 proceedings demonstrate the ILECs have not taken the steps necessary to promote the development of robust competition. Only once they take those steps can their market share begin to reflect effective competition. Given the Section 271 evidence, the fact that the ILECs' market shares remain so high serves only to confirm – not negate as USTA's experts suggest - the meaningfulness (and indeed necessity) of this type of structural measure of ILEC market power.

CONCLUSION

In view of the foregoing, Ad Hoc urges the Commission to reject ILEC claims that forbearance from depreciation regulation is in the public interest in the absence of specific conditions such as discussed in the NRPM and as specifically set forth in Ad Hoc's comments.

Respectfully submitted,

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Certificate of Service

I, Suzanne Takata, hereby certify that true and correct copies of the preceding Reply Comments of the Ad Hoc Telecommunications Users Committee in CC Docket No. 98-137 were served this 8th day of December, 1998 via electronic mail upon the following parties.

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